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INVESTMENTS

Global Equity | Fourth Quarter 2022

What Could Go Right in 2023?
Sentiment will shift at some point; we want to be ahead of the pack.

Warren Buffett has said many clever things over the decades. But the following is one of my favorites: "In the business world, the rearview mirror is always clearer than the windshield." In other words, the past is crystal clear. The future? Not so much. That is why at turning points so many investors stay too long at bull market parties and bail out when bear market routs become too much to bear (pun not intended).

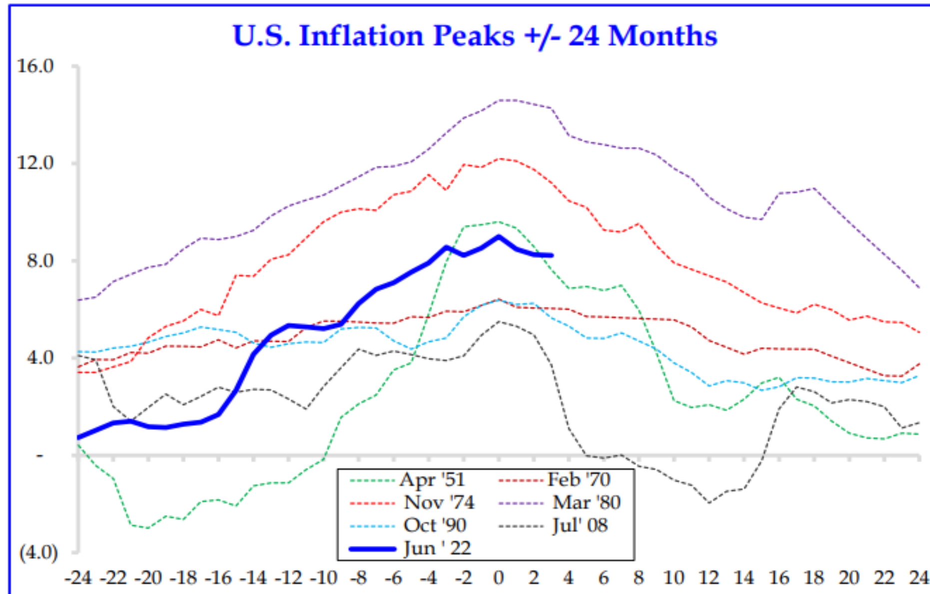
I know I will offend every technical, engineering-focused mind who reads this, but in my experience, investing is about being *mostly right*. (Yes, I know, I know, you can't build a bridge by being mostly right!) An important investing skill lies in sensing when to pivot. While it is nearly impossible to bottom tick the stock market—getting it mostly right can be a victory that pays off in subsequent years. If an investor buys a stock at $100 and it declines to $80 shortly thereafter but hits $300 a few years later, the best question to ask, perhaps, is why that investor didn't buy more. Not why did he buy the stock at all.

We think investors have become way too pessimistic given where we are in the rate hiking cycle. Since March the Fed has raised rates 4.25%--one of the fastest rate hiking regimes in history. And, because monetary policy has a lagged effect on the economy, we expect the economy to slow materially or enter recession at some point in 2023. To be sure a severe recession would be bearish for stocks, yet given the resilience of the U.S. economy and the tight labor market, we are expecting a slowdown or shallow and brief recession. That could allow stocks to rally in the second half of 2023 (after a volatile Q 1) as they look around the recession corner.

Here is what we are watching:

Inflation will continue to roll over. We believe inflation peaked in June. On November 2, 2022, I wrote a piece "How To Make Sense Of The Columbo Economy" Link here the following:

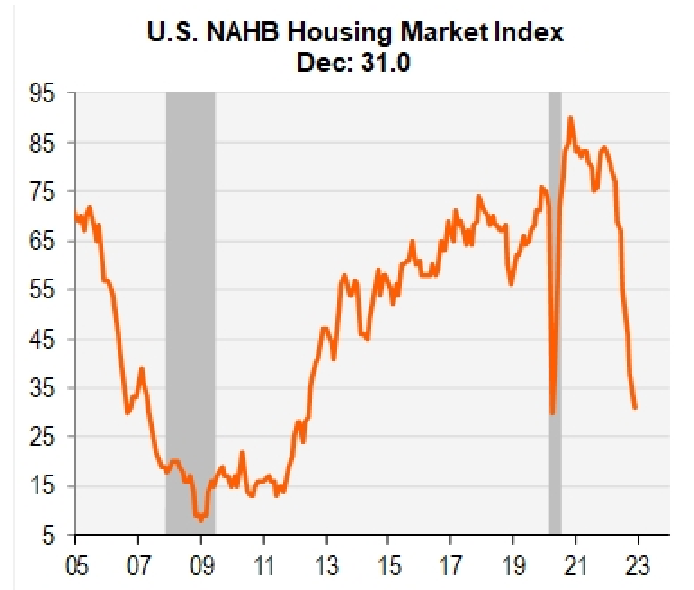
Peak inflation and timing of Fed pause. *It was our contention in the spring of 2021 that inflation would be more persistent and stickier than the Fed's transitory view. We take no comfort in being correct. We have written that we believe peak inflation in the headline CPI was reached in June of this year when it hit 9.1%. And we believe, as history shows, that the rise and fall of inflation is mostly symmetrical. It took 16 months to peak and now we expect it will take a like amount of time to get to a tolerable level (not necessarily 2.0%--the Fed's target).*



Source: Strategas, October 19, 2022

We would emphasize that the trend is not necessarily linear as you can see in the chart above. But, inflation is, indeed, rolling over.

Housing is in freefall, manufacturing PMIs are in contraction, inventories are up, prices paid down, energy costs have come in, used car prices have declined materially as have airfares and hotels, wheat and corn are down, shipping costs have plummeted, copper, aluminum and palladium are well off their highs, and medical insurance costs are set to decline by –40% over the next 12 months. While we don't think the Fed's 2% inflation target is on the horizon, we do think inflation will surprise many to the downside.



Source: Piper Sandler December 2022

Recession likely but not deep. The inversion of the yield curve and the steady decline in Leading Economic Indicators (chart below) almost ensure we see an official recession (versus 2022's slowdown) at some point in 2023. The question? How severe and long will the slowdown in economic growth end up being?

Source: Bloomberg, December 22, 2022

The consumer still has bandwidth and given the tight labor market we think spending will hold up better than the naysayers predict. Which is not to say it won't slow. But generally, we think the bears (never eager to leave the stage) are too pessimistic.

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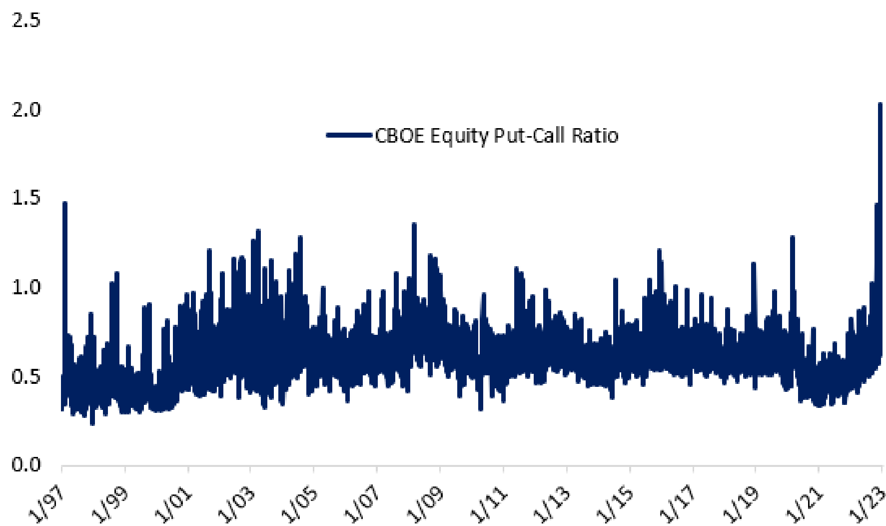
Sentiment is too negative (this is not the 1980s). Recent put volumes outnumbered call volumes by a factor of 2 on the CBOE—the highest level since the data has been measured. The move was driven by a surge in put options and a decline in call options. The put call ratio tends to be a contrary indicator spiking when investors are too pessimistic. Add to that institutional investors have remained on the sidelines with allocations to equities below levels held in 2008!



Source: Bespoke Investment Group, December 22, 2022

What are we worried about?

- The omnibus bill is likely to put upward pressure on inflation just as the Fed is making progress. Another day another $1.8 trillion in spending.
- The transition to onshoring/re-shoring could be a little messy but good news in the long-term. Hundreds of companies have announced their intention to move manufacturing back to the United States. Many are shifting from China to India and Vietnam.
- Geopolitical tension in the South China Sea.

The Bear Market of 2023, if over, would rank as one of the mildest of the 14-prior post—World War II bear markets at 282 days. Interestingly according to our friends at Bespoke Investment Group, this bear market has experienced seven 5% rallies, three of which extended to 10%. Those facts belie the way many feel about this bear market. I have been at this a long time and the only bear market that felt worse was the one that spanned 2001-2003. Investors are exhausted. Ultimately that will bode well for stocks in 2023. Q1 could be choppy (perhaps we will see the price exhaustion indicators marking a bottom then?) but we think the returns on stocks will be positive in 2023, though not necessarily spectacular.

Beware of unintended consequences. When government inserts itself into the free market unintended consequences abound. In 2022, due to high natural gas prices (wind and solar were unable to offset lower energy production from hydro and nuclear power) global coal usage hit an all-time high according to a report by the IEA.

Here's to a Happy and Prosperous New Year!

VB,
Nancy Tengler
CEO and Chief Investment Officer

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GLOBAL EQUITY COMMENTARY:
By Arthur B. Laffer Jr.
President

The European Central Bank ("ECB") has continued the path of trying to manage individual country interest rates over exclusively focusing on fighting high inflation with across-the-board rate hikes. With the US Dollar weakening vs. the Euro this quarter and inflation looking like its moderating we expect a substantial rate hike at the ECBs next meeting, but maybe some hesitation after that for dramatic hikes.

Over in the Asia region the Bank of Japan ("BoJ") has put a stake in the ground and has pledged to not raise interest rates and to continue easy monetary policy for the foreseeable future. But in December they widened the trading range of 10-year treasury bonds from 0-25 basis points up to 50 basis points. The market responded immediately and moved the 10-year treasury yield to 50 basis points and the Yen rallied. This policy is becoming expensive as the BOJ is forced to defend the Yen in the foreign exchange to hinder its decline against other currencies. Inflation is finally starting to rise but remains stubbornly low. So far, all indications are that they will not switch to fighting inflation and that the Japanese Yen will continue to be under pressure against major currencies. We expect that when Chairman Kuroda's term ends this March the BOJ will change its policies and rates will rise in Japan. This is the rationale for removing Japan from the Global Strategy this quarter and replacing it with South Korea. South Korea is just about at the end of their rate hiking cycle and that will in our opinion help equities find footing and the economy finish adjusting to higher rates. Additionally, with China reopening in January this should be a boon for Korean exporters since China is Korea's largest trading partner.

The Chinese economy has suffered significantly and is barely staying above recessionary levels. This is having knockoff effects by reducing export and imports which adversely impacts major trading partners (everyone) as people and business are forced to close and stay home. With the sudden change in national COVID policy China is in for a bumpy ride as demand and supply imbalances shift by massive amounts with the reopening of the economy so quickly. COVID cases have soared, and we are already seeing manufacturing and port logistics issues related to worker health issues. Time will tell how fast China can get its economy moving again and what the final toll will be for its sudden policy change.

It all seems like bad news lately but in reality; this is when opportunities abound. The rate tightening cycle and policy responses to changes in economic events can lead to significant shift in exchange rates and relative growth responses among countries. This is the environment where some countries can really shine while others languish.

MODEL STRATEGY CHANGES

Added
South Korea

Removed
Japan

Top 3 Contributors
- iShares MSCI France ETF
- Franklin FTSE United Kingdom ETF
- iShares MSCI Australia ETF

Bottom 3 Contributors
- Van Eck Vietnam ETF
- iShares MSCI South Korea ETF
- iShares MSCI India ETF

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